WPS 0588

Policy, Research, and External Affairs

WORKING PAPERS

Public Sector Management
and Private Sector Development

Country Economics Department
The World Bank
February 1991
WPS 588

Obstacles to Developing Small and Medium-Sized Enterprises

An Empirical Assessment

Brian Levy

How financing, regulatory, technical, marketing, and other constraints inhibit small and medium-sized enterprises from participating in the economies of Sri Lanka and Tanzania — and what this means for policy.

Policy, Research, and External Affairs

WORKING PAPERS

Public Sector Management
and Private Sector Development

WPS 588

This paper — a product of the Public Sector Management and Private Sector Development Division, Country Economics Department — is part of a larger effort in PRE to understand how to strengthen the private sector in developing countries. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Ernestina Madrona, room N9-061, extension 37496 (62 pages).

Brian Levy analyzes different types of constraints on the participation of small and medium-sized enterprises (SMEs) in the economies of Sri Lanka and Tanzania. He concludes that:

• The type and severity of constraints vary between the two countries:

Lack of access to finance is the binding nonprice constraint on the expansion of all SMEs in Tanzania, and on smaller, less-established firms in Sri Lanka.

In Tanzania, tax and regulatory burdens are the next heaviest constraint on all SMEs. In Sri Lanka, the smallest, least-established enterprises maintain an informal status outside the regulatory web. Larger, established Sri Lankan SMEs are inhibited by a host of nonprice constraints, no one of which is dominant.

• Tanzania's formal and informal financial systems for SMEs are weak. Sri Lanka's financial system for SMEs functions well; firms for which financing is limited are those to which lending would be imprudent. A key policy question is whether targeted credit should be used to accelerate SMEs' access to formal financial institutions (such a World Bank program was important for Sri Lanka's success) and whether banks should use their SME lending apparatus to make loans to microenterprises (which even in Sri Lanka are denied access to formal finance).

• Regulation inhibits the expansion of SMEs in quite different ways in the two countries:

In Sri Lanka, heavy formal tax and regulatory obligations are imposed only on larger firms. Reform priorities there should be to reduce these disincentives to firms achieving formal status and to broaden (but not to the point of universality) the reach of the tax and regulatory apparatus.

In Tanzania, heavy tax and regulatory requirements are imposed on all firms, albeit with pervasive lubrication and renegotiation of formal obligations. There the reform priority should be to exempt the smallest enterprises entirely from regulatory and tax obligations and to introduce more transparent administrative procedures.

• Underdeveloped arm's-length markets for intermediate inputs constrain the participation of SMEs. A prime cause of such market weakness is vertically integrated production by state-owned enterprises, even where there is no economic rationale for such integration. A challenge for privatization is to distinguish between those sectors where vertical integration is efficient and should be maintained when state-owned enterprises are privatized and those where the vertical structure should be broken up, allowing more opportunities for SMEs to participate.

• Educated entrepreneurs in established SMEs that serve high-quality market niches (but not uneducated entrepreneurs serving simpler markets) perceive limits in enterprise and economywide technical and marketing capabilities as significantly constraining expansion. It remains uncertain whether the weakness of support systems signals an underlying market imperfection that only government intervention can overcome.

TABLE OF CONTENTS

		Page No.
I.	SOME PRELIMINARIES	1
	I.1 Structural Adjustment, Micro Constraints, and SME Participation	1
	I.2 The Empirical Approach	4
II.	AN ASSESSMENT OF CONSTRAINTS	9
	II.1 An Overview of the Constraints	9
	II.2 Constraints on Access to Finance	12
	II.3 Regulatory Constraints	21
	II.4 Constraints on Access to Non-Financial Inputs	30
III.	SOME POLICY IMPLICATIONS	40
	III.1 Formulating the Agenda for Reform	40
	III.2 Enhancing Access to Finance	43
	III.3 Reforming the Regulatory and Tax Regime	45
	III.4 Enhancing Access to Non-Financial Inputs	52
	ANNEX A	55

I am grateful to Rafael Herz, Dani Kaufman, Enrique Rueda-Sabater, Mary Shirley, William Steel, Andrew Stone, and Leila Webster for their helpful comments.

OBSTACLES TO THE DEVELOPMENT OF INDIGENOUS SMALL AND MEDIUM ENTERPRISES: AN EMPIRICAL ASSESSMENT

I: SOME PRELIMINARIES

The purpose of this paper is to report the results of micro-level field research conducted in late 1989 and early 1990 of constraints confronting small and medium enterprises (SMEs) in Sri Lanka and Tanzania,[1] and to analyze the implications of these results for reforms to promote the development of an efficient indigenous private sector in LDCs. In doing so, an effort will be made to lay out the empirical methodology in sufficient detail to facilitate parallel studies in other countries where there might be some interest in assessing obstacles to SME development.

I.1 Structural Adjustment, Micro Constraints, and SME Participation

Among the many lessons that have begun to emerge with the accumulation of experience in programs of structural adjustment, two are central to the present paper. First, it has increasingly become apparent that programs of reform that eliminate macro-economic imbalances, bring overvalued exchange rates closer to equilibrium, and promote pricing on the basis of market signals and opportunity costs are not necessarily sufficient to ease the constraints on development. In some countries, rather than securing a

---

[1] The research served as inputs for Tanzania: Country Economic Memorandum (1990) and Sri Lanka: Country Economic Memorandum (1990). Preliminary papers that provide the results of the analyses for each country in more detail than is provided here are available upon request.

rapid and sustained supply response, these broad macro and incentive reforms have brought to the forefront a whole new set of constraints that inhibit the response of the private sector. Further, as the analysis of Sri Lanka and Tanzania underscore many of these newly evident constraints are microeconomic and institutional in character, and so do not lend themselves to the familiar analytical techniques and policy remedies of their macro-economic counterparts.

Second, in many countries the move towards liberal economic policies has brought to the forefront the role of SMEs. In part, this heightened attention reflects the greater opportunities open to SMEs in a liberal environment: in practice (if not necessarily by design), large incumbent public and private firms tend to be favored wherever there are strict direct controls over economic activity and rationed access to foreign exchange or credit. So policies that shift from direct control and rationed access to market allocation result in a significant reduction of discrimination against SMEs. In part, also, there is growing recognition that small enterprises, especially microenterprises with fewer than five workers, can provide a welfare net to alleviate the burden of poverty for people with no foothold in the established public or private sectors. More fundamentally, there is growing interest -- both for narrowly economic reasons and for broader reasons of political economy -- in the potential for SMEs to serve as dynamic agents of economic development. As the experiences of Taiwan and (more recently) Thailand and Indonesia reveal, SMEs hold the promise of building development incrementally on existing national capabilities, and providing a seedbed for the emergence of dynamic and efficient larger national firms even as they support a competitive market environment. Further, there is some indication that development via the expansion and proliferation of SMEs holds the promise of contributing to equitable economic expansion,[2] in part by inhibiting collusive, rent-seeking actions by government officials and powerful incumbents. For all of these reasons, enhancing SMEs is high on the agenda of both government officials and Bank staff active in Sri Lanka and Tanzania -- the two countries that are the subject of the present study.

After failed experiments with thoroughgoing state control of economic activity and widespread public ownership, both Sri Lanka and Tanzania have moved -- albeit at quite different speeds, and with very varying degrees of enthusiasm -- towards more liberal economic policies and more reliance on the private sector. Policy reforms were initiated in Sri Lanka in 1977, and by 1990 the embrace of liberal, pro-private sector policies was virtually complete; even so, as we shall see, Sri Lankan SMEs continue to labor under constraints that are residues of the pre-reform pattern of economic organization. By contrast, policy reforms in Tanzania began only in 1984, and proceeded only haltingly, with little evidence even by early 1990 of any increase in momentum. Yet for all of the limitations, Tanzania's reforms did remove at least some binding constraints -- most notably constraints in access to foreign exchange and imported inputs -- and thereby facilitated a surge in SME activity. Together, analysis of SME participation in the two countries can thus provide some indication of the kinds of constraints SMEs are likely to face at varying stages in the transition from highly distorted towards

---

2. Thus, in the course of the 1970s, the Gini coefficient for Taiwan fell from 0.38 to 0.33; see John Fei, Gustav Ranis, and Shirley Kuo, Growth with Equity: The Taiwan Case, (New York: Oxford University Press, 1979).

liberal economic policies.[3]

1.2 The Empirical Approach

Firm-level interviews were used to learn from SMEs themselves how the relevant public and private institutions (including markets) with which they interact operate in practice, and their relative severity as constraints on enterprise operation and expansion. All interviews combined open-ended and survey approaches, with the open-ended approach given special prominence in early interviews; interview protocols (revised after the initial round of interviews) were used -- an example is included in Annex A -- both to guide the discussion and to provide a basis for subsequent quantitative analysis.

Rather than interview broadly across the spectrum of activities in which SMEs operate, in each country the surveys focused on a narrow group of subsectors which had some potential for comparative advantage, where entry was possible at the smallest scale, and where enterprises could expand incrementally to quite large size. This subsectoral approach facilitates the acquisition of a reasonably in-depth understanding of the context in which the SMEs operate, and thereby enables the interviewer to penetrate beyond superficial responses. The risk is that subsectoral results from relatively small samples might fail to provide a firm basis for broader generalization with sharp differences from sector to sector in the character of the constraints. A priori, constraints associated with imperfections in the

---

[3] While Sri Lanka has been subjected to intermittent civil unrest since 1983, the economic center of Colombo largely has been unaffected. Indeed, as the empirical results below confirm, this unrest is not viewed by SMEs active in the Colombo area as an important constraint on their expansion.

market for finance and with regulations that have broad application are likely to be similar across sectors; by contrast, input, technical and marketing constraints (as well as constraints associated with sector-specific regulations) are likely to be specific to individual subsectors.

In an effort to balance the strengths and weaknesses of sub-sectoral and broad-based approaches, interviews were conducted in three subsectors in each country -- furniture, construction and horticulture in Tanzania, and leather products, ceramics and gemstone calibration in Sri Lanka. In one subsector in each country (furniture in Tanzania, and leather products in Sri Lanka), the enterprise sample was large enough to permit careful quantitative analysis. Analysis in the remaining two subsectors was qualitative, with the objective of exploring whether the quantitative findings were relevant more broadly. Financial and (non-sector-specific) regulatory constraints indeed turned out to have similar impacts across sectors. So what follows focuses largely on the furniture and leather products sectors, with some reference to the other subsectors for those constraints that turned out to be subsector specific in their impact.

<u>Leather products in Sri Lanka</u>. As of mid 1990, Sri Lanka's leather industry comprised a diverse array of participants both upstream and downstream. Upstream, there were a dozen or so tanners, with the state-owned Leather Corporation (which accounts for about 35% of the 11 million square feet of leather tanned each year in Sri Lanka) the largest, followed by two relatively large (together accounting for an additional 35%), and an additional nine or so smaller private firms. Downstream, the bulk of activity was in the production of footwear for the local market, with three major

producers (the multinational enterprise Bata, a downstream division of the Leather Corporation, and a private Sri Lankan firm), some medium-sized enterprises (some of whom produce for their own retail outlets, with others engaged in subcontracting -- most often for Bata), and a host of smaller producers of footwear, including thousands of cobblers active in Sri Lanka. Along with footwear for the local market, two enterprises -- one Japanese, the other Korean -- produced leather footwear products for export throughout Sri Lanka's export processing zone. Footwear aside, there were also a number of producers of other leather products, largely for exports and the local tourist market; these vary in size from relatively large operations to SMEs with fewer than 30 employees. Interviews were conducted with the Leather Corporation, two private tanners, Bata, and 38 locally-owned producers of leather products and footwear in the greater Colombo area.

As the patterns of enterprise participation imply, with the possible exception of tanning, economies of scale in the leather industries are limited, and the scope for SME participation consequently substantial. Further, export patterns suggest that Sri Lanka's comparative advantage in the leather industry is based on an abundant supply of labor skilled in the fabrication of high value added, labor intensive leather products. Exports of these goods -- by the two enterprises located in the export zones, by two relatively large producers of industrial gloves and other leather products that are part of vertically integrated tanning and leather products enterprises, and by a half dozen or so SMEs -- accounted for over 90 percent of Sri Lanka's leather exports in 1987. However, with total exports under $15 million, Sri Lanka has barely begun to tap its potential comparative advantage in the export by both large enterprises and SMEs of high value added, labor intensive leather products. Indeed, with the exception of the two firms located in the export zones, not a single Sri Lankan producer of footwear has yet[4] begun to participate in any sustained way in the export of footwear. The analysis that follows of SME constraints identifies some of the reasons for this limited export performance.

Furniture in Tanzania. The field research on Tanzania's furniture industry was concentrated on the capital city, Dar es Salaam, and its surrounding areas. Participating firms include 5 medium-to-large enterprises whose owners are of Indian origin (or -- in one case -- an expatriate European) and each employ up to 200 workers, 5-10 medium-sized firms (also with owners of Indian origin), half a dozen or so long-established, indigenously owned small-to-medium ventures (some of which were taken over from non-indigenous owners that left the country in the late 1960s and early 1970s), and hundreds (no accurate count is available) of indigenous enterprises that entered the industry in the 1980s, apparently with some acceleration in entry since the initiation of structural adjustment reforms in 1985. Some of the newer, indigenous SMEs have achieved quite substantial incremental expansion, and at the time of interviews employed up to 70 workers.[5] Twenty-four firms were interviewed, including 3 in the medium-to-large category.

---

[4] Bata apparently is beginning to explore export markets, and has set an export target of 10 percent of total sales by 1992.

[5] Thus, 9 of the 13 (randomly selected) post-1980 entrants that were interviewed started up their operations in the 1986-1989 period, and only 4 between 1981 and 1985. See also the aggregate data in the upcoming Tanzania: Country Economic Memorandum that supports this conclusion.

The submarkets served by Tanzania's furniture enterprises range from the completion of large-volume orders for government agencies and the export of processed wood products at the top end of the market, to roadside sales of household furniture to consumers at the bottom-end. Between these extremes firms produced furniture for sale in retail showrooms (in all but one instance marketing was vertically integrated, with the showrooms owned by the manufacturers themselves), supplied high-quality custom designed furniture for higher-income consumers, and produced household furniture on tender to government agencies including parastatals (the agencies, in turn, distribute the furniture as a fringe benefit to higher-level employees). Interviews uncovered evidence of quite substantial mobility among submarkets. Smaller enterprises increasingly have moved into the mid-range of the market: 7 of the indigenous SME interviewees won their first tenders to supply government agencies in the 1980s, all but one of these in the past two years. Although very few retailers purchase from independent manufacturers for subsequent resale,[6] at least one of the expanding enterprises in the sample responded by establishing his own makeshift 'showroom' some distance from his workshop.

Paralleling the movement of smaller enterprises, some larger enterprises are in the process of moving from the mid-range to the top end of the market. One enterprise has recently abandoned entirely furniture manufacture to devote itself to the production for export of parquet flooring and other components of wood; a second enterprise has reduced the share of

[6] One reason for this absence of intermediation at the retail level may be the prevailing sales tax regime which treats as two separate taxable transactions a sale from manufacturer to retailer and then from retailer to final customer, but as only one transaction a sale from a manufacturer through his own showroom to a final consumer.

wood furniture in total sales from 50% to 10%, shifting instead into the production of metal office furniture for the domestic market and the export of parquet flooring and other wood components. An important implication of these moves up-market by larger enterprises is that, rather than being "crowded out", new market opportunities are likely continually to emerge for SMEs seeking to expand. Subsequent sections of this paper will detail many of the obstacles that confront indigenous SMEs as they seek to take advantage of the new opportunities.

II: AN ASSESSMENT OF CONSTRAINTS

II.1 An Overview of the Constraints

The entrepreneurship surveys in the Tanzanian furniture and Sri Lankan leather industries explored with enterprises their assessments of the relative magnitude of obstacles inhibiting their efforts to expand. An initial set of interviews yielded a list of potential constraints to expansion in each industry.[7] Table 1 groups these constraints into four categories: financing constraints; regulatory constraints; technical, marketing and other non-financial input constraints; and cost constraints. As the table details, there was a broad overlap between the two industries (and countries) in the constraints identified, albeit with some variation in the specific ways in which they were formulated.

[7] The small differences in Table 1 between the constraints for Tanzania and those for Sri Lanka reflect differences in the way firms in the two countries classified their constraints.

TABLE 1

ASSESSMENTS BY A SAMPLE OF 38 SRI LANKAN LEATHER PRODUCTS SMES AND 19 TANZANIAN SMES OF THE RELATIVE MAGNITUDE OF OBSTACLES TO EXPANSION

NORMALIZED SCORES BY SIZE OF FIRM

Obstacles	TANZANIAN SMEs	SRI LANKAN SMEs
(a) Financial Market Constraints:		
Lack of Access to Finance	0.97	0.58
(b) Regulatory Constraints:		
Potential Changes in Tax Status	-	0.25
Bureaucratic Procedures	0.67	0.09
Labor Regulations	-	0.07
Policy Uncertainty	-	0.10
Lack of Access to Industrial Sites	0.64	-
(c) Constraints on Access to Non-Financial Inputs:		
(i) Physical Inputs		
Lack of Access to Materials	-	0.41
Lack of Access to Spare Parts	0.38	-
Lack of Access to Wood	0.16	-
Lack of Access to Equipment	0.26	-
(ii) Technical and Marketing Inputs		
Scarcity of Competent Workers	0.14	0.21
Lack of Technical Skills	0.11	0.19
Not Enough Domestic Buyers	0.28	0.11
(d) Cost Constraints:		
Cost of Finance	0.72	0.73
Cost of Materials	0.63	0.61
Cost of Equipment	0.58	0.49
NUMBER OF FIRMS	19	38

For each industry, entrepreneurs were presented with the relevant list and asked to rank each constraint on a scale of 1 to 5 according to its degree of severity. Table 1 summarizes the results obtained after normalizing the scores provided by individual entrepreneurs along a scale of zero (least severe) to one (most severe),[8] and averaging across entrepreneurs the resulting normalized scores for each constraint; the resultant statistics provide cardinal measures of the relative severity of each constraint in each country. The next subsections review and interpret in depth the results obtained for financing constraints, regulatory constraints, and physical input, technical and marketing constraints. But before proceeding with the detailed interpretations, two features of the results and subsequent interpretation are worth noting.

First, although all of the various cost constraints scored relatively high for both industries, they will not receive any further attention insofar as their high scores do not necessarily signal any kind of government or market imperfection. On the contrary, reports by enterprises of high input prices can be interpreted as a signal of significant competitive pressure and an associated squeeze on profits, both of which are desirable

---

[8] Normalization is necessary since there is no basis for comparing the assessments of entrepreneurs as to the absolute magnitudes of severity of the various obstacles. For example, one entrepreneur might choose to rank the entire set of obstacles within the 1 to 3 range, while another -- with identical perceptions of the relative severity of the obstacles -- might scale his ranking in the 3 to 5 range. While the similarities between the two entrepreneurs in the relative ranking of obstacles represents important information for policy, nothing of general usefulness for policy can be learned from evidence of differences among entrepreneurs in their subjective perceptions of the absolute magnitude of challenge posed by the obstacles. Calibration of each firm's assessment of the severity of the obstacles on a scale of 0 to 1 controls for differences among entrepreneurs in their subjective perceptions of the absolute level of difficulty posed by the obstacles they confront.

insofar as they induce enterprises to innovate and become more efficient.[9]

Second, cost constraints aside, there is significantly greater variation in the constraint scores for Tanzania than for Sri Lanka, with the three most binding Tanzanian constraints (lack of access to finance, bureaucratic procedures, and lack of access to industrial sites) all scoring higher than the most binding of the Sri Lankan constraints (lack of access to finance). These results reflect significantly more consensus among Tanzanian than Sri Lankan SMEs as to what are their most binding non-price constraints. For example, the lack of access to finance was identified as the most severe constraint on expansion by eighteen of nineteen respondent furniture firms in Tanzania, accounting for the score of 0.97 (out of a feasible maximum of 1) accorded that constraint in Table 1. As will become apparent below, this variation among the countries in the extent of consensus reflects in turn the contrast between the Tanzanian environment characterized by a few, rigidly binding non-price constraints that inhibit SME expansion, and the significantly less restrictive environment for SMEs in Sri Lanka.

II.2 Constraints on Access to Finance

As the constraint scores in Table 1 reveal, lack of access to finance emerged as the leading non-price constraint on SMEs in both Tanzania and Sri Lanka, albeit with a significantly higher absolute score in the former

[9] Note also the possibility that obstacles associated with high input costs might signal leads and lags in the transmission of macroeconomic policy changes to firms, with the price of some inputs rising rapidly in response to changes in macro variables (the nominal exchange rate, or the rate of inflation to cite two examples) while output prices adjust more slowly.

country. Yet evidence of financing constraints need not imply that there exist imperfections in financial markets that warrant attention by policymakers, since there inevitably will be financially constrained enterprises to whom it would be imprudent for any financial intermediary to lend. Thus, additional empirical analysis is required to evaluate whether the constraint scores signify a serious market failure in securing access to finance on the part of SMEs.

It is helpful to preface the analysis by summarizing briefly what is known internationally as to the financing of small and medium enterprises. The evidence is persuasive[10] that the incentives are weak for formal financial institutions to lend to SMEs: loan sizes are small, so the costs of processing tend to be high relative to loan amounts; the track record and reputation of a putative SME borrower is likely to be limited (as is the system of financial accounting), adding further to the costs of loan processing; and the probability of failure is high even for well-conceived new ventures. Unsurprisingly in the light of these incentive patterns, SMEs worldwide tend to finance the start-up of their operations with savings from the enterprise proprietor, support from family members, short-term credit provided by suppliers, advances offered by buyers, or loans from informal, community-based financial intermediaries who are able to draw on local knowledge as to the reliability of a putative borrower, and on the community sanction of reputation to ensure loan repayment. In general, only once an SME has demonstrated some record of success is it able to tap into the resources of

---

[10] I.M.D Little, Dipak Mazumdar and John M. Page Jr <u>Small Manufacturing Enterprises</u> (Oxford University Press for the World Bank, 1987) pp. 279-287 provide a useful summary of available evidence on SME financing.

the formal financial system.

As Table 2 summarizes, the financing mechanisms of both Sri Lankan and Tanzanian SMEs exhibit some similarities to the stylized general pattern, albeit with some suggestive differences between the two countries. One feature common to both countries is the dominant role of own savings: consistent with the general pattern, all but one of the 58 SMEs for which data were available drew on the savings of the proprietor.

By contrast to the similar role of own savings, there are significant differences between the two countries in the role of informal credit (including trade credit). Paralleling the general pattern, trade credits or informal financial intermediaries each have been used by about 30 percent of the sampled Sri Lankan enterprises, with half the sample having used at least one of these informal sources.[11] Interestingly, 32 percent of the Sri Lankan sample reported using at least one of these sources of informal credit in their initial years of operation, prior to securing finance from the formal banking sector.

In Tanzania, none of the sample enterprises obtained financing via either trade credits or informal intermediaries,[12] although the widespread use of partnerships in that country could be interpreted as representing a substitute channel of informal financing. The absence of trade credit can in

---

[11] 3 of the sampled Sri Lankan SMEs obtained finance via both trade credits and informal financial institutions.

[12] The picture is quite different for non-indigenous entrepreneurs active in Tanzania who apparently have access to well-developed informal mechanisms of financial intermediation.

TABLE 2

SOURCES OF FINANCE FOR 58 SRI LANKAN AND TANZANIAN SMEs
(% OF SAMPLE FIRMS THAT OBTAINED FINANCE FROM EACH SOURCE)

	TANZANIAN FURNITURE SMEs	SRI LANKAN LEATHER SMEs
Own Savings/ Retained Earnings	95.0%	100.0%
Family	25.0	34.2
Partners	45.0	2.6
Formal Financial Institutions	45.0	42.1
Informal Financial Institutions	0.0	28.9
Trade Credit	0.0	28.9
Number of Firms	20	38

part be accounted for by the virtual breakdown of Tanzania's chequing system in the face of both pervasive banking inefficiencies (on which more below) and a legal system which affords only protracted and uncertain recourse; legally-binding post-dated cheques are commonly used as credit and payment mechanisms in countries where firms make extensive use of trade credit. As for the absence of other informal lending mechanisms for indigenous enterprises, here the Tanzanian pattern appears illustrative of a lacuna that is evident throughout East Africa.

Turning to formal finance, in Tanzania a number of financial institutions (all state-owned, as are all financial institutions in the country) have the responsibility in principle for providing financial support to SMEs: a small enterprise lending unit has been operating in the National Bank of Commerce since 1982; since 1974 the Small Industries Development Organization (SIDO) has provided financing for the purchase of new equipment; in principle the Co-operative and Rural Development Bank also lends to SMEs. By contrast to Tanzania, Sri Lanka's banking system is highly diversified, and includes 4 domestic commercial banks (2 government owned), four regional rural development banks, two industrial development banks, 21 foreign commercial banks, and a host of finance companies, leasing companies and insurance companies. At the very least, all 4 domestic commercial banks, both industrial development banks, and the regional rural development banks actively are engaged in lending to SMEs. A comprehensive analysis of the performance of Tanzania's and Sri Lanka's financial institutions is beyond the scope of the present paper. Rather the task here is the narrower one of evaluating that performance from the perspective of the putative borrowers -- the SMEs themselves.

Table 3 disaggregates the Sri Lankan and Tanzanian SMEs with access to formal bank loans by size and age of the enterprises. As the table reveals, only 1 of 18 Sri Lankan, and 1 of 7 Tanzanian SMEs with 5 or fewer employees and less than 3 years of experience had access to formal finance; these patterns of lending are consistent with the theory and empirical evidence summarized earlier that it is entirely rational for banks not to lend to the smallest and least established firms. Coverage within the pool of 'qualifying' clients (those with more than 5 employees, and at least 3 years of experience) appears similar in the two countries, with loans extended to 75 percent (15 of 20) of the qualifying Sri Lankan SMEs, and about 70 percent (9 of 13) of the qualifying Tanzanian firms.

What the data in Table 3 do not reveal are the sharp differences between the two countries in the characteristics of those 'qualifying' borrowers without loans, and in the service afforded to SMEs with loans. Four of the five qualifying Sri Lankan SMEs without loans reported that they were not financially constrained[13], and exhibited no interest in borrowing from banks. By contrast, all 5 of the qualifying Tanzanian firms that were without loans identified lack of access to finance as among their leading constraints.[14] Three of the five were among the most successful and rapidly expanding SMEs in the sample; all three made initial approaches to the banks

Table 3

[13] Each of these 4 SMEs recorded 0 (zero) as their normalized score for access to finance as a constraint on expansion.

[14] The constraint score for lack of access to finance was the maximum possible of 1 for 4 of the 5 firms, and 0.75 for the fifth.

TABLE 3

ACCESS TO FORMAL BANK CREDIT FOR 57 SRI LANKAN AND TANZANIAN SMES BY SIZE AND AGE OF FIRM

Size of Firm	Age of Firm: 0 - 2 Years	3 - 5 Years	6 or more Years	Total
A: Sri Lanka				
1 - 5 Employees	1/8	0/2	0/5	1/15
6 - 15 Employees	0/3	1/2	4/6	5/11
16 or More Employees	-	1/1	9/11	10/12
TOTAL	1/11	2/5	13/22	16/38
B: Tanzania				
1 - 5 Employees	0/3	0/3	-	0/6
6 - 15 Employees	1/1	1/2	2/4	4/7
16 or More Employees	-	0/1	5/6	5/7
TOTAL	1/4	1/6	7/10	9/20

for loans, but without success as of the time of the interviews.[15] In large part, their difficulties can be attributed to the exceedingly burdensome conditions that Tanzanian SMEs must meet if they are to qualify for loans. According to interviewees, loan applicants are required to provide fixed property as collateral; since the banks refuse to recognize leasehold land title (the only form of land title permitted in Tanzania) as collateral, only individuals with the resources to erect physical structures on their land can borrow, and only to the value of these physical structures. Further, along with collateral, applicants are required to provide detailed feasibility studies of their projected investments (even where commercial bank loans take the form of overdraft facilities, typically used for working capital), as well as detailed financial statements. Even with collateral, feasibility studies, and financial statements in hand, firms reported that the processing of loan applications takes an average of six months, and may still require side payments as a precondition for processing.

As for service to SMEs with loans, while Sri Lanka's 16 borrower SMEs appeared satisfied with the service they were afforded, 8 of the 9 SMEs with loans in Tanzania complained bitterly about their relationship with the banks. The difficulties of 3 of the firms appear to be related to the precarious financial condition of the enterprises themselves. But of the remaining 6 (healthy) firms, 2 reported that the bank imposed its own arbitrary loan ceiling thereby disrupting the enterprise's business plan even though all prerequisites for a larger loan had been fulfilled, and 2 others

[15] One firm still had no response two years after the initial application; a second was waited already for six months, and expects an additional one year's wait. The third approached a bank in 1988, but was discouraged by burdensome bureaucracy and a demand for SME payments.

reported that their banker temporarily shut down their overdraft facilities over disputes that were peripheral to the lending relationship itself. The conclusion that emerges from the interviews is that Tanzania's banks do not view their lending to indigenous SMEs in developmental terms, with a goal of identifying and supporting enterprises that have real potential to succeed commercially, and a mutual interest on the part of both the bank and the enterprise in a venture's success. Rather, as indigenous enterprises see it, the banks perceive them to be unwelcome supplicants, to be dealt with only so long as stringent conditions are met and, even then, only so long as the enterprise respects without question the omniscient authority of the lending agency.

In all, the constraint scores and detailed empirical analysis reveal a good deal about the relative importance of lack of access to finance as an obstacle to SME expansion in the two sample countries. In Tanzania, the evidence that finance represents the binding constraint appears unambiguous: not only were Tanzania's SMEs virtually unanimous in scoring lack of access to finance as their leading obstacle to expansion, the disaggregated analysis points to a virtual disintegration of Tanzania's financial system for SMEs. By contrast to Tanzania, only 14 of the 38 SMEs sampled in Sri Lanka identified lack of access to finance as their leading constraint on expansion. Further, consistent with evidence that Sri Lanka's banks rationally choose not to lend to the smallest and least established firms, 8 of the 14 financially constrained SMEs either had been in business for less than 3 years or had 5 or fewer employees; and 3 of the 6 remaining financially constrained SMEs reported current levels of employment to be well below some earlier peak level,[16] suggesting that they might be serious credit risks. Absent these 11 SMEs, Sri Lanka's score for lack of access to finance as an obstacle to expansion falls to 0.41. Together the constraint scores and disaggregated analysis suggest that, while some of the smallest and least established Sri Lankan SMEs indeed appear to be credit constrained, for the more established SMEs the system of financing functions well and is not a serious obstacle to continued expansion.

II.3 Regulatory Constraints

Consistent with the general approach outlined in the introduction, the analysis of regulatory constraints in Sri Lanka and Tanzania focused not on the formal regulations themselves but rather on the impact of these regulations on SMEs. The analysis shows regulatory constraints to be significantly more binding to Tanzanian SMEs than to their Sri Lankan counterparts. Further, it shows that there are substantial differences between the impact that might be deduced from perusal of the formal regulations themselves, and the impact as actually experienced by SMEs. Finally, it shows that regulation can inhibit SME expansion in two quite different ways, with one of these operative in Tanzania, and the other (if to a lesser extent) in Sri Lanka.

The scores for the two sets of regulatory constraints included in Table 1 for Tanzania -- lack of access to industrial sites and bureaucratic procedures -- both are relatively high, at 0.64 and 0.67 respectively. The

---

[16] In all, 7 of the 38 sample Sri Lankan enterprises reported their employment levels as of 1990 as below some earlier, peak level.

catch-all category of bureaucratic procedures subsumes the relations of Tanzanian SMEs with a wide range of regulatory authorities, including sales and income tax authorities, town councils which serve as licensing authorities, providers of public utilities (power, telephone and water), the National Provident Fund, and officials from the Labor Ministry; in practice, as detailed further below, Tanzanian SMEs reported that their bureaucratic difficulties were most substantial with the sales, income tax and licensing authorities. Table 1 provides more disaggregation for the Sri Lankan regulatory constraints, explicitly separating labor regulations and the constraint associated with potential changes in tax status from other bureaucratic procedures that might inhibit SME expansion; the latter includes local licensing requirements, and relations with the providers of public utilities.[17] By contrast to the results for Tanzania, the scores are relatively low for all three Sri Lankan regulatory constraints.

Table 4 decomposes the constraint scores by size and (for Sri Lanka) legal status of SMEs. The decomposition uncovers systematic variation in the impact of regulatory constraints among SMEs, with the pattern of variation different across the two countries. Whereas in Tanzania the scores are largest for the smallest enterprises, in Sri Lanka the scores rise as enterprise size increases for all three sets of constraints, with the rise somewhat larger for the tax constraint than for the others; additionally, independent of size, tax constraints appear to be especially significant for

[17] Access to adequate industrial premises is not included in the category of bureaucratic procedures. While scattered anecdotal information suggests that this might indeed represent a constraint for some SMEs, the Sri Lankan survey was not implemented in a way that could systematically shed light on the issue.

TABLE 4

SCORES FOR REGULATORY CONSTRAINTS AS OBSTACLES TO SME EXPANSION IN SRI LANKA AND TANZANIA, BY SIZE OF FIRM

	Size of Firm			
	1 - 5 Employees	6 - 15 Employees	16 of more Employees	Total
Bureaucratic Procedures				
Sri Lanka	0.02	0.00	0.25	0.09
Tanzania	0.83	0.60	0.62	0.67
Access to Industrial Site				
Tanzania only	0.77	0.62	0.34	0.64
Potential Changes in Tax Status (Sri Lanka only)				
Legal Status				
(a) Unregistered	0.03 (11)[a/]	0.00 (1)[a/]	-	0.03
(b) Partnership/Sole Proprietorship	0.01 (4)[a/]	0.27 (8)[a/]	0.28 (9)[a/]	0.22
(c) Limited Liability Company	-	1.00 (1)[a/]	0.83 (3)[a/]	0.88
(d) All	0.02	0.32	0.42	0.25
Labor Regulations (Sri Lanka only)	0.00	0.05	0.17	0.07
(a) Limited Liability Company	0.00	0.00 (1)[a/]	0.42	0.31
(b) All Others	0.00	0.05	0.08	0.04

a/ Number of Firms in Brackets

the limited liability companies in the Sri Lankan sample.[18]. What accounts for these divergent patterns?

To begin with Sri Lanka, the increase with firm size in the constraint score for bureaucratic procedures can straightforwardly be attributed to administrative obstacles associated with exporting -- the average constraint score was 0.6 for the 5 exporting firms (all in the largest category) but 0.0 for the remaining 7 larger enterprises. As for tax and labor regulation, the explanation for these scores is that compliance with prevailing regulatory and tax obligations by that country's SMEs presently is exceedingly uneven. The formal tax obligations of manufacturers of footwear and leather products are relatively high: a turnover tax amounting to 15% of gross revenues[19], and a tax of 33-50% on net income. In practice, interviewees of all sizes and legal statuses conceded that their tax payments are substantially below the formally mandated levels. Unregistered firms reported that they paid no taxes. Partnerships and sole proprietorships are officially registered and thus cannot maintain the formal invisibility of their unregistered counterparts. However, they are not required to maintain accounts, and consequently enjoy significant discretion as to their declared levels of revenue and profits; consistent with the data in Table 4, a number of firms in this group volunteered in interviews that enterprise visibility (and thus size) was an important determinant of whether (and how thoroughly)

---

[18] Interestingly, although their absolute values were lower than for the tax variable, the average scores for labor regulations and for policy uncertainty -- 0.42 and 0.44 respectively -- were significantly higher for the 4 limited liability enterprises than for the remainder of the sample.

[19] Officials at the Ministry of Finance reported that the 15% rate had recently been increased to 20%; even so, interviewees continued to report that they were subject to a 15% rate.

they might be investigated by the tax authorities. Limited liability companies have less room for manoeuvre, insofar as they are required to maintain audited accounts.[20] Further, as Table 4 implies, the increased visibility of limited liability companies also appears to make them more likely targets of enforcement of labor regulations.[21]

In sum, what the data for Sri Lanka in Table 4 imply is that the opportunities for tax evasion diminish[22] with increases in size and with more formal legal status. Enterprises that grow (or shift to limited liability status) run the risk of suddenly finding themselves liable for very large increases in tax obligations. As a result, many entrepreneurs rationally limit their efforts at expansion.[23] More generally, the variations in constraint score by size and legal status suggest that the combination of high formal tax and regulatory obligations and their uneven enforcement create a discontinuity in the structure of costs of Sri Lankan enterprises as they grow, thereby inhibiting expansion beyond some moderate level, and limiting

---

[20] But even for these companies, the sense was conveyed in interviews that a combination of a low profile and creative accounting could help to limit their tax burden.

[21] Interestingly, although not too much should be read into them, the data suggest that participation in export markets increases visibility and consequent vulnerability to labor regulation: within the largest size category, the average score of the labor regulation constraint was 0.2 for the 4 non-limited-liability exporters, but 0.0 for the remaining 5 non-limited-liability firms.

[22] Put differently, the implication is that the risks and associated costs of tax evasion increase with size and more formal legal status, with concomitant increases in the extent of tax compliance.

[23] One important exception is expansion into export markets, where earnings presently are tax free. However, export growth is also likely to be indirectly limited, insofar as tax obligations inhibit firms from growing incrementally in the domestic market and progressively improving their capabilities to the point that they perceive themselves to be ready to export.

the potential of Sri Lanka's SMEs to serve as a seedbed for the emergence of dynamic national firms.

The constraints created by regulatory practice are quite different in Tanzania. As in Sri Lanka, Tanzania's formal tax and regulatory requirements are demanding. However, unlike Sri Lanka, enforcement is comprehensive, albeit with pervasive lubrication and renegotiation of formal obligations. The net effect of the Tanzanian pattern is to impose entry and expansion-deterring costs on all enterprises, both financial costs and the opportunity cost associated with the diversion of scarce entrepreneurial time and effort away from socially efficient wealth-generating activities;[24] consistent with the scores in Table 4, the relative burden of these costs appears to fall with increases in firm size. The examples of enterprise licensing, and sales and income tax assessment and collection illustrate.

Irrespective of size, all Tanzanian furniture enterprises formally are obligated to license their ventures with local authorities, and formally are liable for very substantial payments of taxes. Enterprises with fewer than ten employees are required to obtain a trading license; enterprises with more than ten employees and enterprises that sell to government agencies are required to obtain a business license. Sales tax for sales of furniture,

---

[24] Interestingly, since for any individual enterprise that is too small to hire a manager the supply of entrepreneurial talent is perfectly inelastic, even if the costs imposed take the form solely of fixed costs that are invariant with enterprise size, they can nonetheless inhibit the expansion of enterprises that have already entered into production. Analytically, the argument is that entrepreneurship is complementary to other inputs into production. Thus, by freeing up the entrepreneur's time to manage his enterprise, a reduction of bureaucratic costs would lead to a downward shift of both fixed and variable cost schedules.

payable by manufacturers (and again by retailers if they operate independently of the producers), is formally set at a rate equal to 25% of sales revenue; income taxes are set at 50% of enterprise profits. In practice, enforcement of Tanzania's tax and licensing requirements (at least in the capital city) was very thorough. All of the interviewees canvassed on the subject confirmed that they were licensed to operate by the Dar Es Salaam City Council. Similarly, with even the smallest furniture enterprises in the sample confirming that they were regularly held liable for tax payment, there appears to be no lower bound on the size of firms that fall within the tax net.

The combination of cumbersome and punitive formal tax and licensing requirements and ubiquitous enforcement create substantial opportunities for officials to extract side payments from even the smallest Tanzanian SMEs. Licenses must be renewed annually. While the fee is modest, and is calculated on a sliding scale according to the size of the enterprise, each renewal is dependent on prior clearance from (among others) the various sales and income tax authorities. In the best of circumstances, obtaining all these clearances and thereafter the license renewal imposes a significant burden on the scarce time of the enterprise proprietor. In circumstances where not all the necessary clearances have been obtained, the proprietor is at the mercy of the licensing official. In practice, incomplete compliance does not appear to have served as a pretext for obstructing entry, or led to the shutting down of enterprises, but instead functions as a vehicle for officials to extract side payments. Hence the report of 7 of 13 interviewees that 'lubrication' is an integral part of the completion each year of license formalities.

Side payments also are ubiquitous in the implementation of tax laws: only 1 of 13 interviewees was willing to characterize the system of tax collection (of both sales and income taxes) as 'legitimate'; the remaining 12 firms confirmed instead that 'lubrication' was pervasive in their dealings with the tax authorities. Nor is harassment by tax officials only occasional. With sales tax legally payable on a monthly basis, tax officials have the opportunity to visit individual enterprises and 'negotiate' their tax burden twelve times annually. In practice, the number of negotiations is somewhat fewer -- the number of visits over the past twelve months by sales tax officials to the thirteen firms that provided information ranged from a low of 2 to a high of 10, with the average 5 per annum -- but the burden on enterprises is hardly trivial; all 4 of the furniture firms that provided a ranking highlighted the burden of dealing with sales tax officials as the most severe of the regulatory obstacles which they confronted. Income tax is payable annually, so in principle the number of legally mandated visits is fewer. However, individual tax assessors have the right to re-examine the accounts of any enterprise at any time on the grounds that inaccurate information has been filed; hence a reported average of 2 visits per annum from income tax officials.

Underlying the improper implementation of tax laws appears to be a broad perception that tax requirements impose an unmanageable burden on enterprises. This perception (together with the low salaries paid government employees) legitimizes[25] for both owners and tax collectors a process whereby

---

[25] To be sure, sometimes the process of renegotiation can be quite antagonistic: one four-person enterprise described how an initial reluctance to 'lubricate' resulted in a sales tax assessment so high that it stood to bankrupt the venture; at that point, the owner had no alternative but to plead

the tax obligations on enterprises are renegotiated (via downward estimates of sales revenue and profits), with associated side payments to the tax assessors themselves. More generally, pervasive lubrication reduces the impact on firms of egregiously unrealistic regulatory policies.[26] Obviously, the pattern of unrealistic policy offset by pervasive lubrication is hardly desirable: corruption is wrong; it gives arbitrary advantages to firms that are more successful in cultivating co-operative relations with public officials; it compels even entrepreneurs who might otherwise prefer to adhere to what is legally required to 'lubricate' the system if they are to survive in a highly competitive environment; and it undermines broadly the capability of the public administration to perform those functions where their contribution is necessary. Even so, from the perspective of private firms, lubrication tempers what would otherwise be a near-impossible environment for conducting business.

As noted, however, the combination of unrealistic policy and pervasive lubrication does not have a similar proportional impact on all firms. The official payments, side payments, and time spent navigating the bureaucratic morass represent entry- and expansion-deterring costs on enterprises, comprising both financial elements and the opportunity cost of

---

with the assessor to accept lubrication in return for scaling down the tax bill.

[26] This judgement does not apply to the constraint associated with lack of access to an industrial site. A recalculation of the constraint score in Table 3 to exclude with access to an industrial site and SMEs that had no interest in expansion yields a result of 0.86, implying that for many entrepreneurs the scarcity of land in Dar Es Salaam allocated to industrial use represents almost as substantial an obstacle to expansion as does lack of access to finance. Further, four of ten SMEs without sites volunteered directly that they would expand if they had access to such a site, implying that insecure land rights inhibit investment.

the fixed resource of the entrepreneur's time. When firms are large enough they can 'grow out' of the costs imposed by an obstructionist bureaucracy: senior executives can delegate the management of relations with the bureaucracy to employees; they can use the influence afforded by their economic power to shield themselves against egregious examples of harassment; and, where necessary, they can cover whatever side payments are required without reducing substantially the working capital available for their business enterprises. Smaller enterprises do not have these options and hence, as the data for Tanzania in Table 5 imply, confront a significantly greater regulatory burden relative to their larger counterparts. In all, Tanzania's regulatory environment has the paradoxical (and presumably unintended) consequence of strengthening the competitive position of large, often non-indigenous enterprises in relation to indigenous SMEs.

II.4 Constraints on Access to Non-financial Inputs

The non-financial inputs considered in this section include physical inputs into production, labor, and technical and marketing skills and information. Unlike constraints associated with regulation or access to finance, constraints in access to non-financial inputs tend to be sector-specific. So, where relevant information is available, this section will draw on survey results from other sectors in addition to furniture and to leather products.

Physical inputs into production. Difficulties in gaining access to physical inputs turned out to be more constraining in both relative and absolute terms in the Sri Lankan leather industry than they were for Tanzanian furniture producers. Not only is the aggregate constraint score for access to physical inputs higher for Sri Lanka than Tanzania, disaggregation reveals a sharp divergence in Sri Lanka (but not Tanzania) in the severity of the constraint by size of firm: the average score for the 15 sample Sri Lankan firms with 5 or fewer employees was a low 0.16 (a reflection of their willingness to make do with odd lots of low quality leather); the average for the 23 remaining (larger) enterprises was 0.55, making lack of access to materials about as binding a constraint to these latter firms as was lack of access to finance.

Underlying the high constraint scores afforded access to materials by Sri Lanka's larger SMEs are some serious imperfections in that country's market for leather: only 3 of the 18 firms in this category that provided information reported adequate quantities of leather of adequate quality to be available; the remaining firms expressed dissatisfaction in one or both of these dimensions. At the root of this dissatisfaction is a longstanding Sri Lankan policy -- even in the face of a manifest absence of any comparative advantage in the supply of tanned leather -- of limiting the rate of expansion of the footwear and leather products industry to the rate of expansion of local tanning capability.

Prior to 1983, the policy of promoting upstream suppliers of leather at the expense of private, downstream producers of leather products took the form of indiscriminate support for the state-owned Leather Corporation. This parastatal was afforded preferential access to local hides, was provided a veto on the entry of potential private competitors and was protected from foreign competition by means of a bar on imports. Further, the

Corporation channelled two-thirds of its production to its own downstream footwear and leather products divisions, thereby restricting even further the availability of leather to private local users. Subsequent to 1983, the restrictions on entry and on access to hides were liberalized. However, while the ban on leather was lifted, a 60% nominal tariff continued to discriminate against imported leather.[27] Further, for all that since 1983 a number of private entrants have begun tanning leather, most of the leather tanned in Sri Lanka still does not find its way onto the open market: approximately 55% of the production of the three leading tanners is transferred to their own downstream operations, and an additional 15-20% sold on contract to the two leading private producers of footwear for the Sri Lankan market; only 25-30% of their output is sold on the open market to independent producers.

While the imperfections detailed above clearly are specific to the market for leather, it is noteworthy that access to materials emerged also in Sri Lanka's ceramics and calibrated gemstone sectors as among the leading constraints on SME expansion.[28] In ceramics, the state-owned Ceramics Corporation has a legal monopoly to mine the requisite inputs for ceramics production (all available in abundance in Sri Lanka), and has used that monopoly to shape the structure of the industry in favor of large enterprises at the expense of SMEs. In gemstone calibration, the State Gem Corporation

[27] With a 200 percent export tax on raw hides, the effective subsidy for tanners is substantially in excess of 60 percent. Interestingly, notwithstanding the widespread claims of unavailability of leather, none of the SMEs interviewed reported that they used imported leather, raising the possibility that there continue to exist non-tariff obstacles to the importation of leather.

[28] This conclusion is a qualitative one, since the number of SMEs surveyed in the two sectors was too small for quantitative constraint scores to be useful.

has been mandated to control -- via the physical inspection of the contents of each and every transaction -- both the export of gemstones, and the importation of uncut stones from abroad for calibration in Sri Lanka and subsequent re-export. It has proceeded with its regulatory function in a manner that (paralleling the earlier discussion on the impact of regulation on Tanzanian SMEs) imposes a disproportionately severe administrative burden for smaller enterprises involved in the export of calibrated gemstones, especially new entrants that have not yet learned their way around.[29] While the materials constraints in leather products, ceramics and gemstone calibration each have idiosyncratic, sector-specific features, all three sectors are characterized by a dominant state-owned enterprise which has shaped industrial organization in a way that discriminates against SMEs. As will be explored further in the conclusion to this paper, this common pattern raises some intriguing questions as to how privatization might be carried out in previously state-dominated economies so as to enhance the opportunities for efficient participation by SMEs.

Turning to Tanzania, the low scores for the obstacles associated with lack of access to equipment, spare parts and wood signify the existence of well-functioning input markets for producers of furniture. In the market for wood, large numbers of indigenous entrepreneurs have specialized at a range of levels, with some procuring wood from local forests via their own

[29] One SME exporter whose experience apparently is not atypical reported that he personally spends two days processing the shipment of an export order, and three days processing the clearance requirements prior to receipt of a parcel of gemstones sent by a foreign buyer on a no-foreign-exchange basis for calibration and re-export. In a typical month, he reported, he has no alternative but to devote fully 50% of his time to overcoming bureaucratic hurdles set up by the State Gem Corporation and by Customs (which operates a parallel apparatus to regulate international trade in gemstones).

agents and then retailing in small lots to urban users, and others coming direct from the countryside and wholesaling lots directly to larger urban users. As for equipment and spare parts, these are purchased from traders who in turn import their wares from abroad. Input markets did not operate as well in Tanzania's construction industry, where lack of access to equipment was identified as the non-price constraint that was most binding after access to finance, and lack of access to building materials also was reported as a significant obstacle. Even so, it is noteworthy that in the construction as well as the furniture industries there was a decline in the perceived severity of constraints in access to physical inputs between the time of entry and of the interviews.[30] One possible explanation for these declines is the greater availability of imported items subsequent to the policy reforms initiated in 1985.

<u>Technical and marketing constraints</u>. The scores in Table 1 for 'lack of technical skills', 'scarcity of competent workers' and 'not enough domestic buyers' are low for both Sri Lanka and Tanzania, implying that on average the sample SMEs do not now perceive shortfalls in these areas to be serious constraints on expansion. It is important, however, not to misinterpret these results: typically, firms in the sample evaluated the obstacles in relation to the markets they were serving at the time of the interviews, and a production quality that sufficed to meet the needs of this

[30] The constraint scores (calculated from a sample of 14 construction firms) for lack of access to equipment and lack of access to building materials as obstacles to expansion were 0.71 and 0.51 respectively; their respective scores as obstacles to entry were 0.94 and 0.86, the leading and second constraints faced by the 14 firms at entry. For the furniture firms, the scores for lack of access to spare parts and to equipment as constraints on entry were 0.49 and 0.45 respectively.

clientele. Yet current practice is not necessarily a reliable basis for evaluating technical and marketing constraints; the relevant constraints are those which enterprises confront in relatively demanding markets. Thus perceptions of constraint might be hypothesized to vary according to both the (market-driven) price and quality requirements of the specific market niches which enterprises seek to serve, and the (entrepreneur-driven) ambition and market awareness of the enterprise proprietors. In practice, patterns of variation emerged most vividly for the technical constraints, so it is on these that the analysis focuses.

Table 5 disaggregates among the sample according to enterprise size, entrepreneur's education, and the 'quality' of the market niches that the enterprise sought to serve. Reflecting overall differences between the two countries in levels of education, in Tanzania entrepreneurs with 10 or more years of schooling were taken to be educated, while in Sri Lanka 13 years of schooling served as the minimum requirement. Sri Lankan enterprises were classified as serving a high quality niche if they subcontracted to Bata or the second large private producer and distributor of footwear (6 firms), if they had made some effort to export (5 firms), or if they sold their products through established, relatively high volume and high quality retail footwear outlets (4 firms);[31] the remaining 22 enterprises in the sample -- including 9 enterprises with 5 or fewer workers that sold all of their output directly from their workshops -- were classified as serving low quality niches. The Tanzanian enterprises serving high quality niches were defined to be those

[31] This last category was defined to comprise firms with over 15 workers that sold their products through retail outlets. Two of the four firms had multiple retail outlets and employed well above 15 workers; for the remaining 2 firms the classification was somewhat more arbitrary.

TABLE 5

CONSTRAINT SCORES FOR LACK OF TECHNICAL SKILLS AS AN OBSTACLE TO SME EXPANSION IN SRI LANKA AND TANZANIA BY SIZE OF FIRM, MARKET NICHE AND ENTREPRENEUR'S EDUCATION

	Number of Employees						
	1 - 5		6 - 15		16 or More		TOTAL
	No.	Score	No.	Score	No.	Score	Score
A: Sri Lanka							
High Quality Market Niche							
Educated Entrepreneur	0	-	3	0.52	9	0.36	0.40
Uneducated Entrepreneur	0	-	0	-	3	0.08	0.08
Low Quality Market Niche							
Educated Entrepreneur	2	0.0	1	0.0	0	-	0.0
Uneducated Entrepreneur	12	0.04	7	0.18	0	-	0.09
	14	(0.32)	11	(0.26)	12	(0.29)	0.19
B: Tanzania							
High Quality Market Niche							
Educated Entrepreneur	0	-	3	0.39	3	0.08	0.20
Uneducated Entrepreneur	0	-	2	0.13	2	0.13	0.13
Low Quality Market Niche							
Educated Entrepreneur	2	0.0	1	0.0	0	-	0.0
Uneducated Entrepreneur	4	0.08	1	0.0	1	0.0	0.06
	6	0.06	7	(0.20)	6	(0.08)	0.11

that sold furniture to government agencies (10 firms) or through retail outlets that were physically independent of the workshop (4 firms, all of whom also sold to government); the remaining 9 (low quality niche) firms all sold their entire output directly from their workshops.

Consistent with the hypothesis that the perception of technical constraint is a function of market- and entrepreneur-driven influences, the data in Table 5 indeed point to systematic variations in perception of technical constraint. Moreover, although the various influences turn out to be highly collinear with one another, there is some evidence that each has some independent effect. Concretely, as is most clearly evident in the data for Sri Lanka, the sample enterprises fall overwhelmingly into one of two quite distinct groups: a group of educated entrepreneurs that employ over 5 (actually, most over 15) workers, with some involvement in high quality market niches, and that appraise technical constraints as quite significant; and a group of uneducated entrepreneurs with 15 or fewer (actually, most 5 or fewer) employees, no involvement in high quality market niches, and no perception that limited technical capabilities might limit their expansion efforts. As for evidence of the independent impact of market-driven and entrepreneur-driven influences, the perception of technical constraint among the SMEs that serve high quality niches is greater for the educated than uneducated entrepreneur; correspondingly, among the SMEs with educated entrepreneurs, the perception of technical constraint is greater among those that serve high rather than low quality market niches.

The weakness of support systems -- market and institutional networks (both private and public) external to the firm -- via which SMEs might learn about new production techniques at the frontier of their capabilities, and about the requirements for penetrating new markets (especially export markets) appears to be an important reason for the technical constraints reported by educated entrepreneurs serving high quality market niches. Only 5 of 15 Sri Lankan leather SMEs serving high quality niches (and none of the 22 serving low quality niches) reported that their enterprise had received some form of technical assistance -- provided to 3 of the 5 by buyers, and to 2 by a foreign expert sponsored jointly by the ILO and the Sri Lankan government; the remaining enterprises reported that the technical capabilities of their staff were acquired by on the job learning -- either in their own firms or as employees of other enterprises. As is attested by the example of the only Tanzanian furniture SME that had organized its workshop on a quasi-assembly line basis consistent with the fulfillment of orders for high volume, technical support systems appear even weaker in that nation than in Sri Lanka. In an effort to upgrade its capabilities, and in the absence of alternative information, the SME placed an order for 4 woodworking machines with a vendor visiting Tanzania from a little-known foreign company and introduced to the firm by its bank. In the event, the enterprise was able to use only 2 of the 4 machines: the third machine (fully paid for) never was delivered; and with the promised technical support for installation and start-up failing to materialize, the enterprise found itself unable to operate the fourth and most expensive machine.

Information is more limited as to support systems for export marketing insofar as only a small minority of SMEs in the two sectors analyzed in the most depth -- two furniture SMEs in Tanzania , and 5 leather product SMEs in Sri Lanka -- had any interest in export markets. There was more export activity -- but less opportunity for data-gathering and analysis -- among Sri Lanka's suppliers of calibrated stones (a sector that produced almost entirely for export) and Tanzania's nascent exporters of horticultural products. Even so, the sample provides an interesting glimpse of the balance between public and private initiatives in establishing channels for export (albeit no basis for uncovering what balance might be efficient).

In the leather products sector, all of the export channels were established privately, with the 2 most successful channels[32] started by foreigners in the course of visits to Sri Lanka for reasons that initially had nothing to do with export procurement. While exports of calibrated gemstones from Sri Lanka got underway only in the late 1970s, exporters were able to build on pre-existing ties with buyers who had long been visiting Sri Lanka to purchase precious, uncut or partially cut gems. In recent years, Sri Lanka's Export Development Board has actively sought to promote participation in the activity, and apparently has provided useful support for new entrants to enter the business, but there is insufficient information to evaluate to what degree this public support has accelerated the expansion of exports of calibrated gemstones. In the Tanzanian wood products sector, the export efforts were entirely at the initiative of the manufacturers (both of Indian origin). Tanzania's Board of External Trade has sponsored a number of visits abroad for potential horticultural exporters, and has thereby been a catalyst for at least some of the emerging interest in the sector. Even so, while none of the horticultural entrepreneurs had as yet established a clear market presence as

[32] Both firms exported more than half of their total production; foreign sales amounted to below five percent of sales of the remaining 3 firms active in export markets.

exporters, the two putative exporters whose plans were most advanced both appear to have acted largely on their own initiatives.

In all, both the constraint scores and evidence as to the character of support systems suggest that technical (and, by extension, marketing) constraints are rather more restrictive than they might superficially appear -- the SMEs who gave technical constraints least weight were those least aware of the technical requirements associated with upgrading their capabilities, while the SMEs with more awareness weighted them somewhat more heavily. Even so, as the concluding section of this paper explores further, recognition that technical constraints bind more stringently than might superficially appear need not necessarily imply that government has an active role to play in their alleviation.

III: SOME POLICY IMPLICATIONS

Analysis of the constraints confronting SMEs in Sri Lanka and Tanzania yields a range of implications for policy reform that are likely also to be relevant for other countries. Some address the general issue of how to go about formulating the agenda for reform of the environment in which SMEs do business. Others address specific reforms in relation to each of the individual constraints.

III.1 Formulating the Agenda for Reform

As the analysis reveals, SMEs operate in a complex environment and confront a diverse array of constraints; it is chimerical to search for a single binding constraint, common across all countries, which once released will set in motion a rapid, sustained process of SME development. Not only is there likely to be substantial variation among countries -- and, within countries, among classes of SMEs -- as to which constraint is binding, the release of one constraint is likely to bring to the forefront some other constraint whose inhibiting influence had not previously been as clearly evident. Yet for all of this complexity, the analysis has outlined a methodology for learning from SMEs themselves what is the relative impact of the various non-price constraints, and detailing how this impact might vary among groups of SMEs.

The applications of the methodology have uncovered quite different patterns of SME constraint in Tanzania and Sri Lanka and, within Sri Lanka, between the smallest and least experienced SMEs on the one hand, and larger and more established firms on the other. The evidence seems unambiguous that lack of access to finance represents the binding constraint on expansion for all classes of SMEs in Tanzania, as well as for smaller, less established firms in Sri Lanka. Further, this constraint appears more severe for the smallest Tanzanian SMEs than for their Sri Lankan counterparts: while formal banks do not lend to the smallest firms in either country, both informal finance and trade credits appear more readily available in Sri Lanka. In Tanzania, the financing constraint was followed -- again for all SMEs, but with a disproportionately severe impact on the smallest -- by the burdens of pervasive and non-transparent tax and regulatory obligations. By contrast, the smallest and least established Sri Lankan enterprises maintained an informal status entirely outside the regulatory web, and reported no difficulties with regulatory authorities. Neither the smallest Sri Lankan nor any of the Tanzanian firms reported technical, marketing or input constraints to be significant obstacles to expansion, although this appears to reflect more the relatively narrow market they currently serve and limited information as to the requirements of more demanding market segments than any underlying capabilities.

The evidence as to which constraints are most binding is more ambiguous for the larger, established SMEs in Sri Lanka. While the financing constraint appears to ease as firms grow, a host of new obstacles -- no one of which appears to be dominant -- come to the fore. Thus larger Sri Lankan SMEs felt constrained by the limited availability of requisite inputs, vulnerable to the risk of heightened scrutiny by tax and other government authorities in the wake of success, limited by weaknesses in their technical skills, and -- for the subsample of enterprises that sought to export -- frustrated by cumbersome bureaucratic procedures and the weakness of institutional mechanisms via which they might link to the international marketplace.

To be sure, learning which constraints bind enterprises is only a first step in setting priorities for reform to promote efficient SME development. Some constraints may not be susceptible to reform. For others, the costs of effective reform may be too high to justify the resultant benefits. Finally, the absence of constraint may signal some undesirable weaknesses in, say, the regulatory environment. What is needed is detailed analysis of the prospects for reform of each constraint, more detailed than is possible in the present paper. Nonetheless, the final sections of the paper draw on the experiences of Sri Lanka and Tanzania to offer some preliminary comments as to how reform might proceed in each constraint area.

III.2 Enhancing Access to Finance

This subsection highlights two financing issues: the provision of credit by formal financial institutions; and the provision of credit to micro-enterprises.

It is difficult to imagine a starker contrast in the performance of formal financial institutions in the provision of SME finance than was evident between Sri Lanka and Tanzania. Whereas Sri Lanka by all accounts represents a model of what can be achieved by a well-functioning system,[33] as outlined earlier the Tanzanian system appears to be in a state of virtual disintegration. Given the evidence that established SMEs rely increasingly on formal finance, and the virtually unanimous view of Tanzania's SMEs that lack of access to finance is their leading obstacle to expansion, reform of Tanzania's banking sector deserves the highest priority.

The Sri Lankan success offers a useful guide to the characteristics of a formal banking sector that can lend effectively to SMEs. Some are the increasingly familiar virtues of a well-functioning financial system: competition among independent banks for borrowers; positive real interest rates (no SME credit is provided at below-market interest rates); determined efforts at collection of outstanding loans (even with ongoing civil unrest, the recovery rate of Sri Lankan banks for loans to SMEs has been in

---

[33] See, for example, the recent review by Leila Webster, World Bank Lending to Small and Medium Enterprises: Fifteen Years of Experience, Industry and Energy Department Working Paper Series No. 20, November 1989.

the 75-90% range). But other characteristics are rather less consistent with prevailing dogmas of financial sector reform. For one thing, the bulk of SME lending appears to have come from credit provided via targeted, World Bank supported SME loans; three loans already have been disbursed, and a fourth is in preparation. For another thing, while both public and private institutions participate in the Bank supported project, by far the largest lender has been the state-owned Bank of Ceylon, followed by the (also state-owned) People's Bank. Further, although there is little difference in the recovery rates of the public and private banks, the public banks have more aggressively sought out borrowers that do not ordinarily have access to formal credit, with the private banks willing to 'cream' the market and service only the most obviously creditworthy SME borrowers. Finally, the Central Bank of Sri Lanka operates a credit guarantee scheme which provides partial coverage for SME lending; while no evaluation of the effectiveness of the scheme is available, it apparently was widely used at least in the initial years of SME lending. The Sri Lankan experience suggests that it is at the very least premature to conclude that the solution to the financing problems of SMEs necessarily lies in the unsupported, market-driven provision of non-targeted credit by competing private banks.

As for the provision of credit to micro-enterprises, even in Sri Lanka the evidence suggests that formal lending programs do not reach the smallest and least well established enterprises. These are precisely the enterprises which are most likely to provide opportunities for self-employment to the least well endowed members of society,[34] a group which in Sri Lanka repeatedly has expressed its discontent by violently challenging the state. For reasons both of equity and of political pragmatism, it might be desirable to make an added effort to extend financing to microenterprises. But it is crucial to recognize that this task is distinct from the task of extending access to formal finance to SMEs, and is likely to involve a quite different set of institutional mechanisms (for example, lending to borrower groups). Special care should be taken to ensure that efforts to pursue the task of poverty alleviation by extending access to finance to microenterprises are not pursued in a way that pressures lenders into making loans they judge to be unviable, and thereby undermines financial systems that have proven themselves effective in the rather different task of reaching those SMEs that have begun to show signs of maturity.

III.3 Reforming the Regulatory and Tax Regime

Much of the debate on regulatory reform has centered around the circumstances in which market failure affords a justification for regulatory intervention. Such debate offers only a partial perspective: a comprehensive analysis should give careful attention not only to the social benefits that regulations are intended to achieve, but also to the costs that they impose on enterprises. Consistent with the overall approach of the present paper, this subsection will analyze the implications for the design of regulatory and tax

---

[34] Of the 17 Sri Lankan entrepreneurs sampled with fewer than 13 years of education, with father's that had fewer than 13 years of education and with only a limited command of English (still the language of business among the elite), 13 were active in enterprises with 5 or fewer workers, and in operation for less than 3 years.

reform of more careful attention to these costs.

It is by now broadly accepted on a priori grounds that a well-functioning regulatory and tax regime should be characterized by a minimum of bureaucratic requirements, and by transparent, moderate obligations imposed across a broad spectrum of enterprises. The empirical analysis uncovered four ways in which the regulatory and tax regimes in Sri Lanka and Tanzania depart from the efficient, a priori model: high formal tax obligations (in both countries); pervasive lubrication (in Tanzania); high bureaucratic costs (especially in Tanzania); and a pattern of selective enforcement that excludes the smallest enterprises from the regulatory net (in Sri Lanka).

In sorting out the impact of these distortions on SMEs and what they imply for policy reform, it is useful to distinguish analytically among three distinct but interrelated burdens -- a fiscal burden, a bureaucratic burden, and a threshold burden. The fiscal burden represents the disincentive effects of taxation -- a disincentive borne by taxpaying firms of all size, and one which increases in magnitude as tax rates rise. As both the Sri Lankan and Tanzanian experiences reveal, analysis of official tax rules can provide a wholly misleading picture of the character of these obligations -- either because (as in Sri Lanka) tax laws are not enforced on small enterprises, or because (as in Tanzania) pervasive lubrication results in there being little relation between the formal obligations and the amount actually paid by enterprises.

The bureaucratic burden represents the costs to SMEs -- most importantly the opportunity cost of the entrepreneur's time -- of dealing with the various agencies of government, with the magnitude of the burden inversely proportional to the efficiency with which the government agencies carry out their assigned tasks. Since presumably governments do not impose bureaucratic tasks simply for the perverse pleasure of tormenting entrepreneurs, the bureaucratic burden is produced jointly with the fiscal burden -- or jointly with the performance of some other task aside from tax collection that government has taken upon itself. Unlike the fiscal burden, the bureaucratic burden is likely to be disproportionately large for the smallest enterprises -- in part because it is in the nature of a fixed cost which is more or less invariant with firm size, and in part because large but not small enterprises can hire managers to whom to delegate many of their dealings with government officials. The empirical analysis suggests that the bureaucratic burden is larger for Tanzanian firms than for their Sri Lankan counterparts -- both because the bureaucracy may simply be less efficient in Tanzania, and because the Tanzanian but not Sri Lankan authorities have extended their bureaucratic net to include even the smallest firms.

The threshold burden represents a discontinuity in the structure of costs that results from the imposition of some tax-related fiscal burden or tax-or-regulatory related bureaucratic burden only on firms larger than some minimum threshold size. Depending on its magnitude, this discontinuity can lead some firms to rein in expansion -- or alternatively to expand via the socially inefficient route of horizontal multiplication of quasi-independent enterprises, all of which remain smaller than the threshold at which the tax and regulatory requirements are imposed. The magnitude of the discontinuity in costs varies with the magnitude of the fiscal or bureaucratic burden imposed by the tax or regulation, while the firm size at which the threshold is reached varies according to how far short of universal is the implementation of the regulatory requirements. As the empirical analysis reveals, the threshold burden appears to deter expansion in Sri Lanka where regulations are applied only to larger firms, but not in Tanzania where application is universal.

Paradoxically, interactions among the fiscal, bureaucratic and threshold burdens can have the effect of offsetting the most egregiously harmful effects of an inefficient regulatory regime; so partial reform can have the unintended effect of worsening the regulatory environment for SMEs relative to the status quo. Thus, in circumstances such as Tanzania's where an excessive fiscal burden is offset by pervasive, bureaucratically costly (as measured by the opportunity cost of entrepreneur's time) lubrication, it is entirely plausible that the environment for SMEs would be worsened by the imposition of measures that sought only to reduce the bureaucratic burden by making regulatory and tax enforcement entirely transparent, and thereby exposed SMEs to the obligation to pay their currently exorbitant tax obligations in full. Conversely, efforts in Sri Lanka to secure universal coverage of the prevailing regulatory and tax regime would eliminate the threshold burden, but replace it instead with a new bureaucratic and fiscal burden for the smallest enterprises.

Given these interactions, regulatory and tax reform needs to proceed simultaneously on four fronts. First, the prevailing web of regulations should be scrutinized, and those that serve no social purpose eliminated entirely (this scrutiny is likely to yield more opportunities for streamlining in Tanzania than in Sri Lanka). Second, where (as in both Sri

Lanka and Tanzania) formal tax obligations are too high they need to be reduced. Third, in parallel with the reduction in formal tax obligations, measures should be taken to secure increased transparency of the regulatory and bureaucratic apparatus, thereby both reducing the bureaucratic burden, and increasing the likelihood that enterprises pay all rather than only a fraction of the taxes they are owed (reform along these lines is especially relevant for Tanzania). Fourth, in parallel with fiscal and bureaucratic reform, decisions need to be taken as to the appropriate reach of coverage of tax and regulatory obligations.

How universal should coverage be? One superficially appealing, but ultimately unsustainable, argument is that coverage should be wholly universal as a way of eliminating the threshold burden. It is true that universal coverage would eliminate an important disincentive to the growth of those enterprises that hitherto had sheltered below the enforcement threshold. But this would be achieved not by removing some underlying obstacle, but by transforming the obstacle from one which inhibits expansion into one which inhibits entry, with equally pernicious -- if less visible -- effects. A more persuasive argument for universal coverage (especially of tax obligations) is that it would broaden the revenue base, and thereby permit lower tax rates and less disincentive to growth by taxpaying enterprises. To be sure, universal coverage would impose a new, expansion-inhibiting fiscal burden on smaller, previously untaxed enterprises. However, some such inhibition is inherent to all revenue-based tax systems; moreover (unlike the bureaucratic burden), with proportional or progressive taxes the fiscal burden is no greater for small enterprises than it is for their larger counterparts. Set against this last argument for universal coverage is the fact that any new fiscal burden necessarily is associated with a corresponding bureaucratic burden. Increasing the extent of coverage not only increases the number of enterprises exposed to the bureaucratic burden, it extends the bureaucratic burden to smaller and smaller firms -- precisely those firms for whom (as the Tanzanian experience exemplifies) the effects are most harmful.

Two implications follow from these competing arguments as to the appropriate extent of coverage. The first implication is that the case for extending the reach of the regulatory net to encompass all enterprises is unambiguous only given the empirically implausible assumption that bureaucracy operates entirely frictionlessly. Put differently, the implication is that the existence of a group of firms excluded from the reach of regulation need not only be a symptom of some underlying policy distortion (the usual rationale for the existence of the so-called 'informal sector'). It may also signify a wise recognition that the imposition of regulatory requirements on enterprises inevitably has some cost, a cost that falls disproportionately on the smallest enterprises. The second implication is that there is no single optimal firm size, identical across countries, below which tax and regulatory obligations should be excused, with firms permitted to operate informally. Rather, the reach of the regulatory net should vary with the administrative capabilities of individual countries. Since large enterprises are better placed to offset the costs of a cumbersome bureaucracy, the weaker is a country's administrative capability, the narrower should be the reach of a country's tax and regulatory apparatus.

Concretely, in both Sri Lanka and Tanzania the first task for regulatory reform is to eliminate regulations now in effect that serve no useful social purpose. Once this task has been achieved, the agendas for regulatory and tax reform are entirely different in the two countries. In Tanzania, the bureaucratic burden represents the primary regulatory constraint on SME development. Thus the priority for reform should be to eliminate the bureaucratic and fiscal burdens on the smallest enterprises by exempting them entirely from regulatory and tax obligations. As a secondary measure, the bureaucratic burden on firms that remain within the regulatory and tax net should be reduced by the introduction of more transparent administrative procedures; even with lower tax rates, this last measure could lead to a somewhat larger fiscal burden for taxpaying firms. In Sri Lanka, by contrast, the primary regulatory constraint on SME development is the threshold burden that results from high regulatory and tax obstacles enforced only on a subset of larger firms. So in that country the priority should be to reduce taxes and the associated fiscal burden on large enterprises, and thereby to reduce the disincentives that inhibit firms from growing into formal status. To maintain the level of tax revenues, this reduction needs to be accompanied by a broadening of the reach of the tax and regulatory apparatus relative to the status quo, thereby imposing new fiscal and bureaucratic burdens on some SMEs that hitherto had effectively been outside the administrative net. Even subsequent to reform, the smallest Sri Lankan firms should continue to remain outside the reach of the regulatory and tax net. Note, though, that insofar as (as the empirical analysis implies) Tanzania's bureaucracy is less efficient than Sri Lanka's, the reach of the regulatory and tax apparatus should extend to smaller enterprises in Sri Lanka than in Tanzania -- precisely the reverse of what is now the case.

III.4 Enhancing Access to Non-financial Inputs

This final subsection will consider the implications of the empirical analysis for reforms to enhance access to physical inputs into production, and to technical and marketing support services.

To begin with access to physical inputs, the empirical analysis uncovered significant difficulties on the part of Sri Lankan SMEs in gaining access to physical inputs in all three of the leather product, ceramics, and gemstone calibration subsectors. With foreign exchange freely available and no other policy-induced rationing in evidence, these difficulties might straightforwardly be attributed to idiosyncratic features of individual subsectors. However, as noted earlier all three sectors are characterized by a dominant state-owned enterprise which has directly or indirectly promoted the emergence of large-scale, vertically integrated operations, and thereby shaped industrial organization in a way that discriminates against SMEs. Given the priority currently being given to privatization in Sri Lanka and elsewhere, the question arises as to whether privatization efforts can perhaps be carried out in a way that redresses the bias against SMEs.

The promotion of product competition -- via imports, private domestic competitors or even sometimes the break-up of state-owned enterprises into independent competing units -- has long been a preoccupation of efforts at privatization. Rather less attention has been paid, however, to the ways in which vertical integration might inhibit competition and SME participation, and thus to how privatization might be undertaken in a way that secures a vertical restructuring of the industry, one that substitutes more-or-less arms length transactions for hierarchical relationships within vertically integrated firms. To be sure, vertically integrated ties established to take advantage of transactional or technological efficiencies of integration or to capture economies of scope should not be disrupted. But there is no reason to maintain vertical integration that emerged arbitrarily as a result of the decisions of state-owned entities, and that inhibits the participation of SMEs, even though it need not be significantly less efficient than arms-length arrangements, and thus would not necessarily disintegrate under the pressure of market competition.[35] The task for reform in this area -- one which in the present context can only be identified -- is to distinguish among those sectors where state-owned enterprises should be privatized as vertically integrated entities, and those where there might be grounds for breaking up the vertical structure into its component parts.

Finally, there is the question of what might be done to strengthen technical and marketing support systems for SMEs. The central policy issue here concerns the appropriate balance between public and private mechanisms for strengthening support. One possibility is that the development of support systems is endogenous -- that the weakness of these systems in Sri Lanka and Tanzania is a reflection, rather than underlying cause, of the rather simple market niches in which SMEs are active and that there will be spontaneous increases in the private provision of technical and marketing support as SMEs respond to new opportunities created by policy reform and take on more

[35] Brian Levy "Transactions Costs, the Size of Firms and Industrial Policy" Journal of Development Economics, forthcoming 1990, and "Strategic Orientations of Firms and the Performance of Korea and Taiwan in Frontier Industries" World Development, forthcoming, 1991, details how the Korean and Taiwanese footwear and computer industries are characterized by entirely different patterns of vertical integration.

demanding challenges. An alternative possibility is that the weakness of support systems signals some underlying market failure,[36] and thus represents an exogenous constraint on SME development, one that can be overcome only via government intervention of one kind or another. Only careful empirical analysis of successful experiences of SME and support system development can reveal which of these competing alternatives is closer to the truth. And since Tanzania and Sri Lanka hardly qualify as successes, that analysis must necessarily be the subject of another study.

---

[36] The putative market failure could plausibly be traced to the public good character of technical and marketing information, and its consequent undersupply by private providers; the case for direct or indirect government support follows straightforwardly. Alternatively, the market failure could be traced to co-ordination problems that undermine the incentive to be the first entrant in circumstances where participation on one side of a market creates positive externalities for participants on the other side; the latter argument implies that the appropriate role for government is as a catalyst that, by providing the initial stimulus, sets in motion a self-sustaining process of private endogenous expansion by SMEs and their related support systems.

Annex A

QUESTIONNAIRE FOR INTERVIEWS WITH LEATHER SMES IN SRI LANKA

I: OVERVIEW

1. Enterprise/entrepreneur name: ______________________

2. Year of start-up: ______________

3. Number of employees: Current: ______________

Start-up: ______________

Peak (year): ____________

4. Employment History of entrepreneur prior to starting enterprise:

II. MARKETS AND MARKETING

A: Markets

1. Items produced ________________

(list leading items) ________________

____

2. What was the largest order for a single item you have received in the last 12 months? [state item and order]

_________ ______________________________

3. What was the value of sales in the past 12 months?

____

4. What percentage of total sales were exports? ___________

5. What were your main export items? ____________

6. In what year did you commence exporting? ____________

B: Export Marketing (if positive exports)

1. Through which of the following channels have you sold your products in the export market?

	Current		At start-up	
1) Foreign buyer	YES	NO	YES	NO
2) Sri Lankan export agent	YES	NO	YES	NO
3) Foreign partner	YES	NO	YES	NO

2. What was your first channel for exports? Explain how the contact was established

3. For your leading buyer of exports:

1) give name ____________

2) % of total exports ____________

3) duration of tie (number of years) ____________

4) how was channel established? (if different from 2 above)

C: Domestic Marketing

1. Through which of the following channels have you sold your products in the local market?

	Current		At start-up	
1) Direct to final consumer:	YES	NO	YES	NO
2) To trader	YES	NO	YES	NO
3) To retail outlet	YES	NO	YES	NO
4) Other: specify	YES	NO	YES	NO

2. What percentage of total domestic sales was made through each of the sources identified in 1:

	Channel	In 1989	In earlier year (if different)
1)	______	______	______________
2)	______	______	______________
3)	______	______	______________

III: INVESTMENT AND TECHNICAL CAPABILITY

1. [Brief description of enterprise building: size, permanence, durability, construction materials, etc....]

2. What were your major investments in capital equipment? (detail pieces)

3. What would be the approximate cost today of setting up your operation as it is now? (replacement cost of assets....)

4. How many employees have specialized skills? [detail these skills]

5. How were these specialized skills acquired?

1) technical training	YES	NO
2) on the job in firm	YES	NO
3) on the job elsewhere	YES	NO

6. For which of the following has your enterprise received technical assistance?

Management	YES	NO
production techniques	YES	NO
product design	YES	NO
marketing	YES	NO

2. For each for which yes, who provided the technical assistance?

(specify)	Skill Area 1:			Skill Area 2:		
Govt. Agency	YES	NO	________	YES	NO	________
Foreign Donor	YES	NO	________	YES	NO	________
Non Government Organization	YES	NO	________	YES	NO	________
Private	YES	NO	________	YES	NO	________

IV: Input Procurement

1. From which of the following suppliers do you procure leather?

   1) state tannery YES NO

   2) private tannery YES NO

   3) wholesaler YES NO

   4) other (specify) YES NO

2. Do you do any leather tanning yourself? YES NO
   If yes, why?

3. Are you able to purchase as much leather as you would like?

   YES NO

   If not, why not?

4. Have there been problems in the quality of leather you purchase?

   YES NO

   If yes, detail

5. What is the share of each of the following in your production costs?

Leather	________
Other raw materials	________
Labor	________
Other	________
TOTAL	100%

V: Financing

1. Which of the following have been major sources of finance?

	(a) Current		(b) At start-up	
1) Own savings	YES	NO	YES	NO
2) Other family member or friends	YES	NO	YES	NO
3) Partners	YES	NO	YES	NO
4) Informal curb market	YES	NO	YES	NO
5) Formal financial institution	YES	NO	YES	NO
6) Suppliers Credits	YES	NO	YES	NO
7) Buyer's Advance Payment	YES	NO	YES	NO
8) Export preshipment finance	YES	NO	YES	NO
9) Other (details)	YES	NO	YES	NO

2. What is the value of your loans from banks:

   (a) Investment loan __________

   (b) Working capital/overdraft facility __________

3. How much of your own funds have you invested in the enterprise?

   ____

4. What percentage of total financing was provided by each of the sources identified in 1:

	Source	In 1989	At start-up
1)	_____	______	__________
2)	_____	______	__________
3)	_____	______	__________

5. If you have received a commercial loan:

   (a) From which institutions(s)? ____________

For each institution

(a) In what year did you receive your first loan? ____________

(b) How long did the application procedure take from initiation to eventual approval? ____________

(c) Was collateral required? Details: ______________________

(d) What other difficulties have you experienced in your relations with the bank? (details)

V: REGULATORY ENVIRONMENT

1. What is your legal status? (select one)

   (a) Unregistered

   (b) Registered as a sole proprietership/partnership

   (c) Incorporated as a Limited Liability private company

   (d) Incorporated as a public company

2. In what year did you

   (a) Register as sole proprietership __________

   (b) Incorporate as limited liability company __________

   (c) Incorporate as public company ___________

3. What problems might you have if you altered your legal status? [Why do you prefer your present status?]

4. Are infrastructural weaknesses a major constraint on growth?

   YES NO

   If yes, give details (road, communications, power)

5. How would you describe your relationship with each of the following government authorities? (pick one)

Turnover tax authorities	EASY	MODERATE	DIFFICULT
Income tax authorities	EASY	MODERATE	DIFFICULT
Labor department	EASY	MODERATE	DIFFICULT
Customs (if applicable)	EASY	MODERATE	DIFFICULT
Power Authority (if app)	EASY	MODERATE	DIFFICULT
Telephone Authority (if ap)	EASY	MODERATE	DIFFICULT
Any other regulatory authority with which you have problems (specify)	EASY	MODERATE	DIFFICULT

6. For those authorities for which the relationship is 'difficult', describe the problems you encounter:

7. Are you eligible for export/investment incentives?

YES NO

8. If yes,

(a) what incentives have you received:

(b) what difficulties have you had in using these incentives?

VI: LONG-TERM OBJECTIVES

1. What size of business would you like to have two years from now? (Circle one).

MORE THAN TWICE PRESENT SIZE 50% LARGER SAME SMALLER

2. If you plan to expand, what steps have you taken for achieving your objective?

3. If you plan to expand, can you raise additional finance? explain

VII: ORDINAL RANKINGS

A: Obstacles to expansion

On a scale of 1 (lowest) to 5 (highest), which of the following are the most important obstacles to expanding your operation?

	Insignificant		Some		Strong
(a) not enough domestic buyers	1	2	3	4	5
(b) not enough export orders (if trying to export)	1	2	3	4	5
(c) Lack of technical skills	1	2	3	4	5
(d) Scarcity of competent workers	1	2	3	4	5
(e) potential changes in tax status	1	2	3	4	5
(f) labor regulations	1	2	3	4	5
(g) bureaucratic procedures	1	2	3	4	5
(h) infrastructural weaknesses	1	2	3	4	5
(i) Lack of access to finance	1	2	3	4	5
(j) High cost of finance	1	2	3	4	5
(k) Lack of access to raw materials	1	2	3	4	5
(l) High cost of raw materials	1	2	3	4	5
(m) High cost of equipment	1	2	3	4	5
(n) Political/policy uncertainty	1	2	3	4	5

VIII: HISTORY OF ENTREPRENEUR

1. Age : ________________
2. Years of formal education:
   (If college, specify degree) ____________________
3. Language of schooling: ________________
4. Father's primary occupation: ____________________
5. Father's years of formal education: ______________________
6. Language at home: ______________

PRE Working Paper Series

	Title	Author	Date	Contact for paper
WPS568	Higher Wages for Relief Work Can Make Many of the Poor Worse Off: Recent Evidence from Maharashtra's "Employment Guarantee Scheme"	Martin Ravallion Gaurav Datt Shubham Chaudhuri	January 1991	C. Spooner 30464
WPS569	Domestic Purchase Requirements for Import License Allocations in Mali	Wendy E. Takacs	January 1991	S. Fallon 37947
WPS570	Debt Concentration and Secondary Market Prices	Raquel Fernandez Sule Ozler	January 1991	S. King-Watson 31047
WPS571	Credit's Effect on Productivity in Chinese Agriculture: A Microeconomic Model of Disequilibrium	Gershon Feder Lawrence J. Lau Justin Y. Lin Xiaopeng Luo	January 1991	C. Spooner 30464
WPS572	Capital Positions of Japanese Banks	Edward J. Kane Haluk Unal Asli Demirguc-Kunt	January 1991	S. King-Watson 33730
WPS573	Malaysian Labor Markets Under Structural Adjustment	Dipak Mazumdar	January 1991	M. Schreier 36432
WPS574	Public Policies and Saving in Developing Countries	Vittorio Corbo Klaus Schmidt-Hebbel	January 1991	S. Jonnakuty 39074
WPS575	Household Saving in Developing Countries: First Cross-Country Evidence	Klaus Schmidt-Hebbel Steven B. Webb Giancarlo Corsetti	January 1991	E. Khine 39361
WPS576	Lessons from Tax Reform: An Overview	Wayne Thirsk	January 1991	A. Bhalla 37699
WPS577	Africa's Rising Inflation: Causes, Consequences, and Cures	Ajay Chhibber	February 1991	B. Dhomun 39413
WPS578	The Bank's Use of Technical Assistance for Institutional Development	Beatrice Buyck	January 1991	E. Madrona 37496
WPS579	Chile's Experience with Stabilization Revisited	Vittorio Corbo Andrés Solimano	January 1991	E. Khine 39361
WPS580	Do Natural Resource-Based Industrialization Strategies Convey Important (Unrecognized) Price Benefits for Commodity-Exporting Developing Countries?	Alexander J. Yeats	January 1991	J. Jacobson 33710

PRE Working Paper Series

	Title	Author	Date	Contact for paper
WPS581	How Successful is World Bank Lending for Structural Adjustment?	Patrick Conway	January 1991	S. Fallon 37947
WPS582	Adjustment Programs and Bank Support: Rationale and Main Results	Vittorio Corbo Stanley Fischer	January 1991	L. Oropesa 39075
WPS583	World Bank Lending for Education Research, 1982-89	Marlaine E. Lockheed Alastair G. Rodd	January 1991	C. Cristobal 33640
WPS584	Whither Hungary and the European Communities?	Alfred Tovias Sam Laird	January 1991	G. Ilogon 33732
WPS585	Financial Innovation and Money Demand: Theory and Empirical Implementation	Patricio Arrau Jose de Gregorio	January 1991	S. King-Watson 31047
WPS586	The Challenging Arithmetic of Poverty in Bangladesh	Martin Ravallion	February 1991	WDR Office 31393
WPS587	Quantifying the Magnitude and Severity of Absolute Poverty in the Developing World in the Mid-1980s	Martin Ravallion Gaurav Datt Dominique van de Walle Elaine Chan	February 1991	WDR Office 31393
WPS588	Obstacles to Developing Small and Medium-Sized Enterprises: An Empirical Assessment	Brian Levy	February 1991	E. Madrona 37496
WPS589	To Prescribe or Not to Prescribe: On the Regulation of Pharmaceuticals in Developing Countries	Jeffrey S. Hammer	February 1991	O. Nadora S6-065